

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
RISK MANAGED ABSOLUTE RETURN STRATEGIES PROGRAM**

February 14, 2005

This Policy is effective immediately upon adoption.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Risk Managed Absolute Return Strategies Program ("the Program", "RMARS"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of the global capital markets.

II. STRATEGIC OBJECTIVE

Broadening the opportunity set of the System's investment portfolio for achieving investment returns not available in traditional public markets investments is the strategic objective of investing in Absolute Return Strategies through the Risk Managed Absolute Return Strategies Program.

Absolute Return Strategies are offered in a limited partnership or limited liability company (LLC) form, when the majority of the underlying investments are publicly traded. Absolute Return Strategies may include, but are not limited to Relative Value Funds, Market Neutral Funds, Arbitrage Funds, Fund of Funds, and Long/Short Equity Funds.

Absolute Return Strategies shall be selected to accomplish the following:

- A. Enhance the System's long-term total return, subject to the careful management of risk, consistent with an appropriate risk budget.
- B. Hedge against long-term liabilities.
- C. Provide diversification to the System's overall investment program.

- D. Consider solely the interest of the System's participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

- A. The **System's Investment Committee** ("the Investment Committee") is responsible for approving and amending this Policy. The Investment Committee delegates the responsibility for administering the Risk Managed Absolute Return Strategies Program to the System's Investment Staff through the Delegation of Authority (Delegation Nos. 89-13 and 95-50).
- B. The **System's Investment Staff** ("the Staff") is also known as the Absolute Return Strategies Advisory Board. This Board is comprised on senior investment professionals from within CalPERS. Their duties include, but are not limited to, the following responsibilities:
 - 1. Developing and recommending this Policy to the Investment Committee.
 - 2. Implementing and adhering to this Policy.
 - 3. Evaluating and selecting absolute return strategies investment opportunities. Staff shall seek Investment Committee approval when an allocation to a specific absolute return strategy product causes the total investment in the product to exceed \$200 million.
 - 4. Evaluating and selecting Absolute Return Fund Strategic Partner(s) through a focused competitive solicitation process. The selection process shall use specific criteria with the objective of identifying and selecting Absolute Return Fund Strategic Partner(s) that have, but are not limited to, the following characteristics:
 - a. Multiple senior personnel with significant amount of experience in the hedge fund industry.
 - b. Breadth of expertise across many fund strategies.
 - c. Highly quantitative disciplines for risk controls.
 - d. Sound quantitative process for constructing a portfolio.
 - e. Attractive fee arrangements.
 - f. Desire to work with CalPERS in a labor intensive fashion.
 - g. Committed to providing CalPERS access to the very top people within their organization.

- h. The ability to assist CalPERS in securing scarce capacity and position level transparency from hedge funds.
 - 5. Monitoring selected Investment Partner(s) to determine if the partners' actions and investment results are consistent with the System's manager monitoring policies. Monitoring may be accomplished through a Absolute Return Fund Strategic Partner(s) or Staff.
 - 6. Reporting to the Investment Committee monthly performance reporting, concerns, problems, material changes, and all violations of Guidelines and Policies immediately and in writing, along with explanations and appropriate recommendations for corrective action.
 - 7. Overseeing the reconciliation of each investment by the Hedge Fund Administrator in accordance with US Generally Accepted Accounting Principles on a monthly basis. The Hedge Fund Administrator shall provide an accounting ledger each month to the Staff.
- C. The **Absolute Return Fund Strategic Partner(s)** duties shall include, but are not limited to, the following responsibilities:
- 1. Conducting the initial screening of potential absolute return fund investments.
 - 2. Performing front and back office due diligence and evaluating the legal terms of prospective absolute return fund investments.
 - 3. Preparing a recommendation to staff on any action that is to be taken (hire or fire, reduce or increase exposure) within the Risk Managed Absolute Return Strategies Program.
 - 4. Monitoring and evaluating the performance of the absolute return funds in the Risk Managed Absolute Return Strategies Program relative to the appropriate benchmark and this Policy, in accordance with its contract with the System.
 - 5. Constructing and managing a fund of funds for the Program.
- D. The **General Partner(s)** is responsible for all aspects of portfolio management as set forth in the General Partner's contract with the

System and shall fulfill the following duties:

1. Communicate with Staff as needed regarding investment strategy and investment results. The General Partner(s) is expected to monitor, analyze, and evaluate performance relative to the agreed-upon benchmark.
2. Cooperate fully with the System's Staff, Hedge Fund Administrator, and Absolute Return Fund Strategic Partner(s) on requests for information.
3. Comply completely with the System's reporting requirements, including but not limited to, accounting for fees and expenses.

IV. PERFORMANCE OBJECTIVE

Absolute Return Funds are highly specialized investments; therefore, the System shall establish performance objectives for each absolute return fund. These objectives shall be set at levels that are consistent with the strategy employed by the hedge fund manager.

A. Risk Managed Absolute Return Strategies Program

1. Target Level Risk

The Program level risk target shall be no greater than one-half the five year annualized volatility of CalPERS' Internal Wilshire 2500 Equity Index Fund, and that the Program shall be managed so that in any one month the decline in net asset value shall not exceed 10%.

2. The Return Target

On an annual basis and for purposes of performance appraisals, the return target shall be the return of the one-year U.S. Treasury Bill rate plus 5% over a full market cycle (three to five years).

3. Liquidity

Expected liquidity for the majority of absolute return funds and fund of funds within the Program shall be subject to an initial lock-up of 1-year and quarterly liquidity thereafter.

V. INVESTMENT APPROACHES AND PARAMETERS

A. Approach

1. Absolute return funds shall compliment the traditional active management vehicles in the Global Equity Markets and AIM Investment Programs. Absolute return fund investments may include exposure to leverage or short selling of securities or both. The allocation of assets for the Program shall come from the active or passive investments from the Global Equity Markets Program.
2. The Program shall use absolute return funds to generate the attractive risk-to-reward characteristics provided by these specialized and unique investment strategies.
3. The Program shall invest in absolute return funds through partnerships or other formation structures, e.g., limited liability companies (LLCs), where the general partner(s) or fund manager(s) have expertise in the specified mandates and in related areas material to the success of each investment strategy. The justifications for a limited partnership or LLC structure include, but are not limited to, the following:
 - a. Financial Firewall: The limited liability of a partnership or LLC arrangement is important since absolute return funds sometimes use derivatives and leverage. The System, as a limited partner, has the benefit of this limited liability.
 - b. Access Unique Approaches with Limited Liquidity: The key to successful absolute return fund investing is in selecting vehicles where the specialization of the investment is sufficiently unique that the partnership or LLC structure is justified in limiting asset growth in the strategy, ensuring a proper investment time horizon, and protecting the System from the vagaries of other investors who may not be like-minded. The goal is to ensure that the approaches selected for recommendation do not mirror traditional active management. The fees and expenses of investing in absolute return funds may be higher than traditional active management. The System shall not fund absolute return funds that simply invest in traditional active management approaches at higher fees.

- c. Access Unique Talent: The specialized and focused nature of absolute return funds often requires more specialized investment skills than those needed for traditional active management. Some of these investment professionals manage money only in the partnership format or LLC structure.
- 4. The negotiation of terms in absolute return funds shall protect the interests of the System, and shall address at a minimum the following issues:
 - a. Alignment of Interests: Vehicle terms including fees shall be negotiated to ensure the alignment of the General Partner's interest with the System. The management fee, carried interest, performance objective, return of capital, lock-up period, clawbacks, and other relevant terms shall protect the System in the event of adverse performance results, while ensuring that the limited liability status is maintained. Where appropriate, a return of capital commitments shall be negotiated.
 - b. Leverage: It is recognized that absolute return strategies may expose the System's assets to leverage, meaning that a partnership's market exposure may exceed the market value-adjusted capital commitment by the amount of borrowed capital. Therefore, investments should only be made in investment vehicles (specific to absolute return funds) which provide limited liability. The limited liability structure protects the Risk Managed Absolute Return Strategies Program from losing more than its invested capital.
 - c. Reporting Requirements: To appropriately account for fees, individual expenses, invested capital, and any other items affecting the investment, Staff shall prescribe a standard reporting format, which all the General Partners shall follow.
- 5. The Staff and consultant shall continually review the efficacy of absolute return fund investment vehicles. The Staff shall present a formal review of the approach to the Investment Committee on an annual basis.

B. Investment Selection

1. Absolute return funds may be selected if they enhance the Risk Managed Absolute Return Strategies Program's ability to achieve the overall investment objective. Absolute return funds may include investments in domestic equity, international equity and fixed income securities that may include, but are not limited to, the following *strategies* (as defined by the leading industry-recognized hedge fund indices):
 - a. Directional Trading
 - b. Event Driven
 - c. Multi-Process
 - d. Security Selection
 - e. Specialist Credit
2. The following absolute return fund investment *styles* shall be considered for the Risk Managed Absolute Return Strategies Program that may include, but are not limited to, the following (as defined by the leading industry-recognized hedge fund indices):
 - a. Convertible Arbitrage
 - b. Distressed Securities
 - c. Fixed Income Arbitrage
 - d. Long/Short Credit
 - e. Long/Short Equity
 - f. Market Neutral
 - g. Merger Arbitrage
 - h. Multiple Arbitrage
 - g. Statistical Arbitrage
 - h. Commodity Trading Advisors
3. The Staff shall develop and maintain selection guidelines for prospective absolute return funds. These criteria shall be subject to review by:
 - a. The Absolute Return Strategies Advisory Board,
 - b. The Absolute Return Fund Strategic Partner(s), and
 - c. The consultant representing the CalPERS' Investment Committee to ensure conformity to the return and risk expectations of the CalPERS' Investment Committee.

The selection guidelines may include, but are not limited to the following:

- a. Minimum requirements with respect to the following:
 - (1) General Partner Investment Experience
 - (2) Basic Investment Vehicle Terms
 - (3) Investment Goals and Objectives
 - (4) Degree of Leverage
- b. Performance Criteria
- c. Due Diligence Process
- d. Legal Constraints or Requirements
- e. Reporting Requirements
- f. Quality control processes including, but not limited to, investment monitoring and risk control
- g. Other relevant parameters that may apply

C. Investment Parameters

Investment partner(s) in Absolute Return Strategies shall operate under a limited partnership agreement, or other similar legal structure, which includes specific, written investment guidelines. The guidelines shall outline the investment partner(s)' investment philosophy and approaches, representative portfolios characteristics, permissible and restricted securities and procedures, and a performance objective commensurate with the investment risk to be incurred.

Implementation of this Program shall comply at all times with the applicable System investment policies.

D. Risk Parameters

Each RMARS investment shall have specified a set of risk parameters appropriate for that investment. Staff shall utilize the risk platform that has been internally developed to measure and monitor quantitatively the economic and investment risks associated with the Program, and shall further utilize the judgments and advice of the ARS program Strategic Partner(s) and the General Investment Consultant to the Investment Committee to assess the qualitative risks inherent in managing the Program.

VI. BENCHMARKS FOR ABSOLUTE RETURN FUNDS

Due to the wide range of markets in which these investments shall be made, appropriate benchmarks shall be established for each specific absolute return fund investment vehicle. The benchmark shall reflect the investment opportunity set or risk profile of each investment. These

benchmarks shall be established prior to investment and shall be documented with each absolute return fund manager.

VII. GENERAL

- A. Terms in this policy are defined in a master glossary of terms.
- B. Investors, managers, consultants, or other participants selected by the System shall make all calculations and computations on a fair-market-value basis as recorded by the System's Hedge Fund Administrator.

VIII. GLOSSARY OF TERMS

The Equity Glossary of Terms is referenced in the System's Master Glossary of Terms.